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IN THE

Supreme Court of the United States

[redacted] TERM, [redacted]

No. 994

[redacted]
[redacted],
Petitioners,

v.

[redacted]
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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[redacted]
[redacted]
[redacted]
Counsel for Petitioners

[redacted]

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. .....

WILLIAM L. MITCHELL and
MARIAN S. MITCHELL,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PRAYER

The petitioners William L. Mitchell and Marian S. Mitchell pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on June 18, 1970.

OPINIONS BELOW

The opinion of the Tax Court, reported at 52 T.C. 170, and the opinion of the Court of Appeals for the Sixth Circuit (not yet reported) reversing the decision of the Tax Court appear in the Appendix hereto.

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was entered on June 18, 1970. A timely petition for rehearing *en banc* was denied on August 7, 1970, and this petition was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATEMENT OF THE CASE

The following facts, which are taken from the Tax Court opinion, are undisputed since the Court of Appeals accepted the findings of the Tax Court as correct (Ct. of App. at 4):

On October 5, 1962, the petitioner William L. Mitchell, a vice president of General Motors Corporation, sold 2,736 shares of General Motors stock, of which 2,130 shares brought $54.75 a share. After commissions and taxes he netted $115,535 on the sale of these shares (52 T.C. at 171). He and his wife filed a joint income tax return for 1962 and reported the profit as a long-term capital gain (52 T.C. at 171).

On January 10, 1963, the petitioner exercised a restricted stock option, which had been granted to him in March 1959 under the General Motors Stock Option Plan, to purchase 2,130 shares of General Motors common stock at the option price of $45.82 per share (52 T.C. at 171). Petitioner used a portion of the proceeds from the 1962 sale of his General Motors stock to pay a total of $97,596.60 for the shares (52 T.C. at 171). Subsequently the petitioner was advised by General Motors that in its opinion the purchase of the stock under the stock option was in violation of §16(b) of the Securities Exchange Act of 1934 because the petitioner was an "insider" who had sold and purchased stock within a six month period (52 T.C. at 171-72). Accordingly General Motors made a demand upon the petitioner for $17,960.29, representing the difference between $115,535.89, the net proceeds from the sale of 2,130 of the 2,736 shares on October 5, 1962, and the $97,596.60 he paid on January 10, 1963, upon the exercise of a stock option for 2,130 shares (52 T.C. at 172).

The petitioner was advised that under Securities and Exchange Commission Rules, General Motors would be required to report the transaction on a Proxy Statement if he did not make the requested payment (52 T.C. at 172). The petitioner reasonably believed such action might damage his business reputation and disadvantage his career wtih General Motors (52 T.C. at 172). He was advised by counsel that he might not be liable to General Motors under §16(b), but was advised further that he should nevertheless pay the requested amount (52 T.C. at 172). Therefore he paid General Motors $17,960.29 in order to avoid injury to his business reputation, disadvantage to his career, embarrassment to General Motors and himself, and the expense of possible future litigation (52 T.C. at 172, 173). The petitioner did not admit his liability by making the payment and expressed his belief that he was

not an "insider" within the meaning of Securities and Exchange Commission Rule and Regulations (52 T.C. at 172).

On his income tax return for 1963, the petitioner claimed an ordinary and necessary business expense deduction in the amount of $17,939.29, which amount represented his payment to General Motors (52 T.C. at 172). The respondent allowed a deduction only for a long-term capital loss, relying upon the tax benefit doctrine set forth in this Court's decision in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952) (52 T.C. at 173).

The Tax Court found that the petitioner's payment to General Motors was deductible as an ordinary and necessary busines expense because the payment was made by the petitioner in the belief that it would avoid injury to his business reputation, embarrassment to General Motors and himself, and possible expensive litigation (52 T.C. at 176). The Court of Appeals reversed the Tax Court, relying upon this Court's decisions in *Arrowsmith v. Commissioner, supra*, and *United States v. Skelly Oil Company*, 394 U.S. 678 (1969). Notwithstanding its adoption of the Tax Court's findings, the Court of Appeals stated that the business purpose of the petitioner in making the payment to General Motors was irrelevant in determining the tax consequences of the payment because of the application of the tax benefit doctrine (Ct. of App. at 7).

REASONS FOR GRANTING THE WRIT

The Court of Appeals has decided that this Court's decisions in *Arrowsmith* and *Skelly Oil* require it to treat an ordinary business expense payment as a capital loss when the payment is made from the proceeds of a prior transaction which resulted in a capital gain. The Court of Appeals, in interpreting and applying the tax benefit doctrine set forth in *Arrowsmith* and *Skelly Oil*, concluded that the petitioner's payment to General Motors—which it and the Tax Court found to be a business expense—must be treated as a capital loss because it "had its genesis in a transaction in which the taxpayer realized a long term capital gain". This is an erroneous interpretation of the doctrine which will not only confuse many taxpayers in their ordinary day-to-day transactions, but will also result in inequities far beyond the spirit and law of this Court's decision in *Arrowsmith v. Skelly Oil*. This Court should review this decision in order to set forth guidelines for the proper application of *Arrowsmith* and *Skelly Oil*.

The interpretation of the tax benefit doctrine made here by the Court of Appeals leads to the following result: An employer, needing cash to meet his payroll, sells assets in a transaction which results in a capital gain. He then uses the proceeds to pay his employees' salaries, a transaction which would ordinarily result in a deduction from ordinary income. The Court of Appeals would deny an ordinary deduction on the salary payments because the proceeds used to make the payments were obtained in a capital transaction. The sale of assets would be as related to the payment of salaries as the petitioner's sale of stock was related to a payment to protect his business reputation. Under the decision of the Court of Appeals the

business purpose of paying salaries would be irrelevant just as the business purpose of protecting one's reputation was declared to be irrelevant.

The tax benefit doctrine, as described by this Court in *Arrowsmith* and *Skelly Oil*, states that the tax consequences of a transaction are controlled by the tax treatment of a prior transaction when the present transaction is a necessary adjustment resulting from some defect in the prior transaction. The decision here is a gross extension of the doctrine so that it applies even where, as the Tax Court said, "there is no relationship between the amount of the capital gain realized upon the sale transaction to which [the Commissioner] would relate the loss and the amount which 'inures' to the stock issuer under Section 16(b)".

In *Arrowsmith* the stockholders reported as a capital gain the profits from the liquidation of their corporation. However, the stockholders had to return a portion of the distributions at a later date as a result of a judgment against the corporation for which liability was imposed on them as transferees of the corporate assets. This Court allowed the stockholders only capital losses upon return of the proceeds and said the tax treatment of the proceeds when returned must be consistent with the tax treatment of the proceeds when received. Similarly, in *Skelly Oil* the taxpayer was required to refund overcharges to its customers upon which it had taken a depletion deduction upon receipt of the funds. This Court required that the taxpayer's deduction in the year of the refund be adjusted for the depletion allowance allowed in the year of receipt.

In the *Arrowsmith* and *Skelly Oil* cases the subsequent transaction occurred as a result of a necessary adjustment to a prior transaction. In contrast, the first transaction here, whereby the petitioner sold his General Motors stock,

was complete in itself and was never adjusted. The proceeds were his to keep; there was no claim-of-right problem as there was in the *Skelly Oil* case. As the Tax Court observed—

> In the instant case in 1962, when petitioner sold General Motors stock, he reported a long-term capital gain and paid the resulting tax. That gain was then his property without a claim against it on the part of anyone. It was a completed transaction (52 T.C. at 174).

The petitioner's later payment to General Motors, as found by the Tax Court and confirmed by the Court of Appeals, was made to protect the petitioner's business reputation. The payment to General Motors had no relationship to the after-tax result of the petitioner's prior sale of his General Motors stock. Even if the sale had resulted in a loss to the petitioner, he would still have made the payment to General Motors. Thus the *Arrowsmith* and *Skelly Oil* cases are inapplicable since the petitioner's payment to General Motors was not made as a result of some necessary adjustment arising from the prior sale of stock in 1962.

In spite of the absence of a relationship between the tax gain on the first transaction and the later payment to General Motors, as shown in the findings, the Court of Appeals has treated the amount paid to General Motors as if it were related to the earlier sale; it says this result is required by *Skelly Oil*. This interpretation of *Skelly Oil* necessarily reaches into and changes the tax effect of numerous ordinary business transactions. A taxpayer is thus now required to "trace" the proceeds of every transaction resulting in capital gain or loss to prevent the loss of an ordinary deduction for a subsequent business expense because of the "taint" of the prior transaction.

This broad application of *Skelly* by the Court of Appeals disregards entirely the limitation recognized by this Court as stated on page 686 of the Opinion:

> "In addition, the approach here adopted will affect only a few cases".

If the Court of Appeals' interpretation of *Skelly* is adopted it will affect many cases. In fact, it will transcend the tax laws.

This Court should review the Court of Appeals' erroneous decision; otherwise no taxpayer can be assured of the tax consequences of a later transaction in which he uses the proceeds of a prior transaction.

Furthermore, it has come to the attention of counsel for the petitioner that there are many other taxpayers involved with the Internal Revenue Service in similar controversies. Counsel has been contacted by the counsels for four other taxpayers who are presently at some stage of the administrative process of the Internal Revenue Service with cases involving payments to corporation employers for "alleged insider profits". These cases involve taxpayers in the Second, Tenth and Sixth Circuits. It was the Court of Appeals for the Sixth Circuit, of course, that rendered the decision below which petitioners now seek to have reviewed.

Only by reviewing this decision will this Court be able to establish one uniform precedent for these and all other similar cases when they come to trial.

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

HARRY S. STARK,
Attorney for Petitioners
2255 Penobscot Building
Detroit, Michigan 48226

Dated: October 30, 1970

APPENDIX A

52 T. C. No. 21

TAX COURT OF THE UNITED STATES

William L. Mitchell and Marian S. Mitchell,
Petitioners,

v.

Commissioner of Internal Revenue,
Respondent.

Docket No. 2522-67

Filed April 30, 1969

Respondent has determined that on a stock sale-purchase transaction, within the meaning of sec. 16(b) of the Securities Exchange Act of 1934, payment by petitioner to his employer of the difference between the sale price of the stock sold and the purchase price of the stock purchased, constitutes merely a capital loss under the principles enunciated in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). Petitioner contends the payment constituted an ordinary and necessary business expense under sec. 162(a), I.R.C. 1954.

Held, *Arrowsmith* principles not applicable. *Held, further*, petitioner's payment constituted deductible ordinary and necessary business expense.

Harry S. Stark and *Leonard J. Prekel*, for the petitioners.
Robert T. Hollohan, for the respondent.

Withey, Judge: A deficiency in income tax has been determined by the Commissioner against petitioners for the taxable year 1963 in the amount of $12,364.28.

The only issue to be decided is whether respondent has erred in disallowing as an ordinary and necessary business expense deduction the amount paid by petitioner to his employer in response to an alleged violation of section 16(b) of the Securities Exchange Act of 1934 and allowing the deduction only as a long-term capital loss.

Findings of Fact

Some of the facts have been stipulated and are found accordingly.

William L. Mitchell (hereinafter referred to as petitioner) and Marian S. Mitchell were husband and wife with legal residence at Birmingham, Michigan, at the time the petition was filed. They filed their joint Federal income tax return for the taxable year 1963 with the district director of internal revenue at Detroit, Michigan.

Since 1958, petitioner has been a vice president in charge of styling for the General Motors Corporation (hereinafter referred to as General Motors).

On October 5, 1962, petitioner sold 2,736 shares of General Motors common stock, of which 2,130 shares were sold at $54.75 per share. After commissions and taxes, he netted $115,[illegible]35.89 on the sale of such shares.

On petitioners' 1962 income tax return, the sale was reported as the sale of a capital asset and they reported the gain on the sale as a capital gain.

On January 10, 1963, petitioner exercised a restricted stock option, which had been granted him in March 1959 under the General Motors Stock Option Plan, to purchase 2,130 shares of General Motors common stock at the option price of $45.82 per share. Petitioners paid a total of $97,596.60 for the shares.

At the dates of the sale and purchase of the stock above referred to, petitioner was not aware of the provisions of section 16(b) of the Securities Exchange Act of 1934 (hereinafter referred to as section 16(b)). His sale and purchase of the stock were made on the advice of counsel in the planning and organizing of his estate.

These transactions came to the attention of General Motors. General Motors then advised petitioner that in their opinion the transactions violated section 16(b),[1] and

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[1] Section 16(b) provides as follows:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

made a demand upon him for $17,939.29, representing the difference between the amount he received from the sale of 2,130 shares of General Motors stock on October 5, 1962, and the cost of acquiring a similar number of shares by exercising the stock option on January 10, 1963.

Petitioner was advised by counsel that there was a theory under the which he might not be liable to General Motors under section 16(b), but that he should nevertheless pay the requested amount. Pursuant to that advice, petitioner remitted $17,939.29 to General Motors in settlement of his alleged violation of section 16(b) but specifically did not admit his liability thereunder in so doing, and expressed his belief that he was not an "insider" within the meaning of SEC rules and regulations. No administrative or judicial determination of petitioners' liability under section 16(b) had been made at the time of this payment.

Under Securities and Exchange Commission rules,[2] if petitioner had not voluntarily paid the $17,939.29 to General Motors, the alleged section 16(b) transaction would be required to be reported on the General Motors Proxy Statement, which is furnished annually to over 1 million stockholders and petitioner reasonably believed that such action might damage his business reputation and disadvantage his career with General Motors. Furthermore, had petitioner not made this payment, there was a substantial likelihood that General Motorss would have instituted an action against him based on section 16(b) to recover that sum.

On petitioner's joint income tax return for 1963, they claimed an ordinary and necessary business expense deduction in the amount of $17,939.29, which amount represented the payment to General Motors.

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[2] General Rules and Regulations of the Securities Exchange Act of 1934, Item 7(e) of Schedule 14A, Information Required in Proxy Statement.

Ultimate Finding of Fact

Petitioner's payment of $17,939.29 to General Motors was made to avoid injury to his business reputation and disadvantage to his career, embarrassment to General Motors and himself, and the expense of possible future litigation.

Opinion

Petitioner seeks to deduct the amount of the payment made to his employer as an ordinary and necessary business expense under section 162(a) of the Internal Revenue Code of 1954.[3] The respondent, by his adjustment, has allowed a deduction only for a long-term capital loss on the theory of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

Petitioner's argument in favor of an ordinary and necessary business expense deduction is premised upon his contentions that: (1) he is in the business of rendering services to his employer, (2) that his payment of $17,939.29 to General Motors was not made because of a violation of section 16(b), and (3) that such payment was made solely to prevent damage to his business reputation, to prevent embarrassment to himself and his employer, to avoid the expense of litigation, and to protect his position as an employee.

Respondent agrees that petitioner's employment as a corporate executive may constitute a trade or business separate and distinct from that of his employer, but takes

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[3] SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business • • •

issue with petitioner that any damage to his business reputation would have resulted from his failure or refusal to make the payment in question. In addition, by his allowance of a long-term capital loss to petitioner in the statement accompanying his notice of deficiency and by statements contained in his brief, respondent raises another issue which, so far as we have been able to determine, has not been previously decided. He contends that petitioner previously reported a capital gain on his sale of General Motors stock and that petitioner's payment of the alleged section 16(b) "profit" was so closely related to the earlier sale as to require the payment's characterization as a capital loss under the rationale of *Arrowsmith v. Commissioner, supra.*[4] In effect, he contends that the question whether or not petitioner made the payment to protect his business reputation is therefore irrelevant. We do not agree.

In *Arrowsmith,* the taxpayers received distributions upon the complete liquidation of a corporation and reported the resulting profit as a capital gain. In a later year, the taxpayers, as transferees of the corporation's assets, paid a judgment against the corporation and claimed a deduction as an ordinary loss. The Supreme Court held that it was proper to consider the earlier transaction in order to classify the nature of the later loss, and determined that the liabilities paid in the later year were "directly related to" and "tied together" with the earlier liquidating distributions and, therefore, the later deductions should be treated as capital losses. From the *Arrow-*

[4] Respondent's position in this case stems directly from his view as expressed in Rev. Rul. 61-115, 1961-1 C.B. 46, that: "The income tax significance of the capital stock dealings giving rise to the [section 16(b)] payment determines whether there is an ordinary deduction or a capital loss."

smith decision have flowed a number of other cases where, because of the integral connection of a taxable transaction in a later year to a taxable transaction in an earlier year, the character of the gain or loss in the later transaction is determined by the capital or noncapital nature of the gain or loss in the earlier one. *Alvin B. Lowe*, 44 T.C. 363 (1965), gain incurred by retention by seller of part of purchase price of stock after default by buyer, held to be capital gain; *Rees Blow Pipe Manufacturing Co.*, 41 T.C. 598 (1964), affd. per curiam 342 F.2d 990 (C.A. 9, 1965), amount paid by seller in satisfying judgment for misrepresentation in sale of building, held capital loss; *Estate of James M. Shannonhouse*, 21 T.C. 422 (1953), amounts paid by seller of realty to purchaser in discharge of liabilities for breach of covenant of title, held capital loss.

In the instant case in 1962, when petitioner sold General Motors stock, he reported a long-term capital gain and paid the resulting tax. That gain was then his property without a claim against it on the part of anyone. It was a completed transaction. In 1963, petitioner purchased other shares of General Motors common stock at a price fixed by stock options owned by him. Upon this latter transaction, nothing of tax consequence took place. Only upon the sale or disposition of the purchased stock could it be said that anything with tax incidence had occurred. Secs. 1001, 1002, I.R.C. 1954. Because the purchase of the stock in 1963 took place within 6 months of the sale transaction, however, an entirely separate and distinct statute from the Internal Revenue Code was alleged to have come into operation, i.e., section 16(b) of the Securities Exchange Act of 1934. Violation of section 16(b) has no *ipso facto* tax effect whatsoever but merely creates an indebtedness between an "insider" officer of a corporation and his corporate employer.

It is noteworthy that there is no relationship between the amount of the capital gain realized upon the sale transaction to which respondent would relate the loss and the amount which "inures" to the stock issuer under section 16(b). The fact is that a violation of section 16(b) could well occur where the sale transaction had actually resulted in a loss to the violator, but the measure of the amount which inures to the stock issuer under its provisions remains the same. For example, if X Corporation stock with a basis of $20 is sold for $10 ($10 loss), and within 6 months other X Corporation stock is acquired for $5, under section 16(b) there is a $5 "profit" that inures to X Corporation.[5] See, Loss, Securities Regulation 1062 (2d Ed., 1961).

It appears clear to us that it may not be said with respect to the transactions herein that the payment to the stock issuer grew out of either the earlier sale or later purchase of stock taken singly. Rather, it grew directly and solely from the "sale-purchase" occurrence, which has only securities law significance, and the effect of section 16(b) thereon. Thus, we think respondent's attempt to relate the payment to the stock issuer under section 16(b) to the earlier sale of stock conflicts with the realities of the situation.

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[5] Violation of section 16(b) may also occur where there is a purchase of stock followed by a sale of stock of the same corporation. The stock sold need not be the same stock that was previously purchased within the 6-month period. (Loss, Securities Regulation 1058 (2d Ed., 1961)). Thus, it is again possible to have an economic loss yet a section 16(b) profit, e.g., purchase of X Corporation stock at $5 followed by a sale at $10 of previously acquired X Corporation stock with a basis of $20, results in a $10 economic loss on the sale but a $5 section 16(b) "profit." If, however, the stock sold is the same stock that was purchased within 6 months, the issue raised by respondent in this case, i.e., capital gain followed by ordinary deduction, does not arise since any sale of stock held for less than 6 months will give rise to short-term capital gain which is taxed as ordinary income.

Further divorcing the payment in question here from either stock transaction is the fact which we have found that petitioner's payment to General Motors was made for reasons other than concession of liability for violation of section 16(b). Such payment was made after he was advised that there was reasonable ground to doubt that he was an "insider" within the meaning of that section. It was clearly made without any admission that he was in violation thereof and prior to any judicial or administrative decision to that effect.

In sum, it appears to us that the underlying element in the *Arrowsmith* line of case law is the existence of an integral relationship between two taxable transactions in separate years, so that the characterization of the latter transaction by the earlier one is necessary in order to reflect the true taxable income of the taxpayer. Only by such reasoning does the logic of those decisions become evident. The payment in the instant case has no such relationship to the capital gain on the sale of the General Motors stock and we see no principle of tax law which requires its treatment as a capital loss.

Thus, we are left with the question of whether petitioner's payment of the $17,939.29 constitutes an ordinary and necessary business expense. Expenditures incurred by a taxpayer to protect his business reputation or to avoid unfavorable business or commercial publicity have been regarded as deductible. *Paul Draper*, 26 T.C. 201 (1956); *William L. Butler*, 17 T.C. 675 (1951). The case of *Lawrence M. Marks*, 27 T.C. 464 (1956) is directly in point. In that case we held that payment to a corporation of "insider's profits" under section 16(b) was deductible as an ordinary and necessary business expense, where the principal motives of the taxpayer in making the payment were

to avoid unfavorable publicity with possible injury to his business reputation and to avoid the expense which further negotiation and, possibly, litigation would bring. See *Joseph P. Pike*, 44 T.C. 787 (1965). We have found as a fact that the payment by petitioner herein was made in the belief that it would avoid injury to his business reputation and embarrassment to General Motors and himself, as well as possible expensive litigation. Nor can we say that petitioner was unreasonable in this belief. Cf. *Old Town Corporation*, 37 T.C. 845 (1962). Respondent contends that petitioner has failed to establish by evidence that failure to make the payment in question would actually have resulted in damage to his business reputation. We hold that if from the evidence adduced it appears petitioner had a reasonable basis for his belief that damage would result to his business reputation and career, that is sufficient. This record contains ample evidence of such reasonable basis for his belief. Thus, we hold that the payment in question is deductible as an ordinary and necessary expense of petitioner's trade or business of being an employee. *Laurence M. Marks, supra; Joseph P. Pike, supra; cf. Vincent E. Oswald*, 49 T.C. 645 (1968); Rev. Rul. 69-115, I.R.B. 1969-11, 9.

Reviewed by the Court.

Decision will be entered for the petitioners.

Drennen, J., concurring: I cannot agree with the majority opinion that because the payment "grew directly and solely from the 'sale-purchase' occurrence" it has only securities law significance and no tax law significance. I would not dismiss *Arrowsmith v. Commissioner*, 344 U.S. 6, so readily. Had there been no other overriding business reason for the payment, I think the rationale of *Arrowsmith might* require treatment of the payment as a

capital loss, if it is deductible at all. However, the majority opinion has made an ultimate finding of fact that the payment was made to avoid injury to petitioner's business reputation and disadvantage to his career with General Motors, which I accept as a factual determination by the trial judge. If this was the ultimate reason for the payment I doubt that *Arrowsmith* would require treatment of the payment as a capital loss, rather than a business expense, even though the payment may have had its genesis in the "sale-purchase occurrence."

It occurs to me that this payment might in reality be considered an additional cost of the new stock petitioner purchased under the stock option and should be treated as a capital investment rather than as either a deductible loss or expense, but it is my understanding that this argument was not made to the Court.

Tietjens, J., agrees with this concurring opinion.

APPENDIX B

No. 19950

UNITED STATES COURT OF APPEALS
for the Sixth Circuit

William L. Mitchell and Marian S. Mitchell,
Petitioners-Appellees,

v.

Commissioner of Internal Revenue,
Repondent-Appellant.

Appeal from the Decision of the Tax Court of the United States

Decided and Filed June 18, 1970.

Before Phillips, Chief Judge, and Edwards and Peck, Circuit Judges.

Phillips, Chief Judge. The question presented on this appeal is whether a payment made by a taxpayer to his employer for an alleged "insider" profit in a stock transaction, which was in the nature of a business expense but which had its genesis in a transaction in which the taxpayer realized a long term capital gain, should be treated as a long term capital loss. Stated differently, the issue is whether the tax benefits doctrine of *Arrowsmith v. Commissioner*, 344 U.S. 6, controls under the facts of the present case.

In an opinion published at 52 T.C. 170, the Tax Court decided the case in favor of the taxpayer. The Commissioner appeals. We reverse.

The taxpayer, William Mitchell,[1] is a vice president of General Motors Corporation (hereafter General Motors) in charge of styling. On October 5, 1962, he sold 2,736 shares of General Motors common stock, of which 2,130 shares brought $54.75 per share. After commission and taxes he netted $115,535 on the sale of these shares. He reported the profit as a long-term capital gain on his 1962 income tax return.

On January 10, 1963, the taxpayer exercised a restricted stock option, which he had acquired in March 1959 under the General Motors stock option plan. He purchased 2,130 shares of General Motors common stock at the option price of $45.82 per share, a total of $97,596.60.

The Securities and Exchange Act of 1934, § 16(b), 15 U.S.C. § 781p (1964 ed), referred herein as § 16(b)[2] pro-

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[1] Mrs. Mitchell is a party to the action only because she filed a joint return with her husband.

[2] Section 16(b) provides as follows:

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent juris-

(continued on next page)

hibits the buying and selling or selling and buying within a six months period of the stock of a corporation by an insider. If such a transaction occurs the corporation must either be paid the difference between the two prices of the stock or the corporation must show the amount on its annual report as a debt owed to the corporation.

The taxpayer was not aware of the provisions of § 16(b) at the time he entered into the sale and purchase of the stock here in question. He made the transactions upon the advice of a banker in the planning and organization of his estate.

General Motors learned of the transactions and advised the taxpayer that in the opinion of its General Counsel he had violated § 16(b). Demand was made for payment of $17,939.29, the difference between the selling price and the purchase price of the 2,130 shares which were both sold and purchased within less than six months.

The taxpayer was informed that if he did not make the payment the alleged § 16(b) violation would be shown in the General Motors proxy statement distributed annually to all General Motors stockholders. He concluded that such publication could hurt his relationship with General Motors. It also is likely that had he not paid it vol-

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(continued from preceding page)

diction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

untarily he would have been sued by General Motors to recover the amount alleged to be due.

At no time has the taxpayer admitted that he violated § 16(b). No judicial or administrative determination as to his liability under § 16(b) has been made.

The taxpayer was advised by his attorney that there was a theory under which he might not be liable to General Motors under § 16(b) but that under all the circumstances he nevertheless should pay the requested amount. Pursuant to this advice taxpayer remitted $17,939.29 to General Motors in settlement of his alleged violation of § 16(b), but specifically did not admit his liability thereunder in so doing. He expressed his belief that he was not an "insider" within the meaning of the SEC rules and regulations.[3]

On his 1963 income tax return the taxpayer claimed an ordinary and necessary business expense deduction in the amount of $17,939.29, representing his payment to General Motors in satisfaction of his alleged liability under § 16 (b). The Commissioner disallowed the deduction and allowed the taxpayer only a long-term loss deduction.

The Tax Court held that the payment was deductible as a business expense, making the following ultimate finding of fact:

> "Petitioner's payment of $17,939.29 to General Motors was made to avoid injury to his business reputation and disadvantage to his career, embarrassment to General Motors and himself, and the expense of possible future litigation."

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[3] Section 240.3b-2 of the General Rules and Regulations, Securities Exchange Act of 1934 (17 C.F.R. § 240.3b-2).

Reference is made to the decision of the Tax Court for a more detailed recitation of the facts. 52 T.C. 170.

The Commissioner makes the following concession in his brief:

> "The Commissioner does not now disagree that taxpayer made the payment in question because he believed failure to make the payment would damage his career at General Motors, and that under some circumstances the payment could be an ordinary deduction for a business expense. The Commissioner does contend, however, that this is not such a case and that the rule of *Arrowsmith v. Commissioner*, 344 U.S. 6 (to the effect that an income tax deduction must be characterized by the income item in which it had its genesis and without which it would not have been paid) is governing here and takes precedence over the Code provision allowing ordinary business expense deductions."

This appeal presents a question of law and not of fact. The findings of fact of the Tax Court are not clearly erroneous and will be accepted as correct for the purposes of disposing of the appeal. Rule 52(a), Fed. R. Civ. P.

In *Arrowsmith* the taxpayer received payments in 1937-40 in liquidation of a corporation jointly owned with another and reported the payments as capital gains. In 1944 a judgment was rendered against the corporation and one of the owners individually. Each paid one-half of the judgment and deducted the entire amount paid as an ordinary business loss. The Supreme Court held that the losses should be treated as capital losses even though occurring in a later year since they were an integral part of the corporate liquidation and not an ordinary loss.

The Tax Court held that the tax benefits doctrine of *Arrowsmith* does not apply under the facts of the present case. The decision of the Tax Court does not cite *U.S. v. Skelly Oil Co.*, 394 U.S. 678, in which the Supreme Court applied the doctrine of *Arrowsmith*. The *Skelly Oil* opinion was announced on April 21, 1969, only nine days prior to the release of the decision of the Tax Court in this case. Presumably the decision of the Tax Court already was in the hands of the printer at the time the opinion in *Skelly Oil* was announced. Thus the Tax Court decided the present case without having the benefit of the latest pronouncement of the Supreme Court in applying the tax benefit doctrine of *Arrowsmith*. From our study of *Skelly Oil* this Court is convinced that if the Tax Court had considered *Skelly Oil* it would have applied the *Arrowsmith* doctrine in the present case and held that the amount paid by the taxpayer to General Motors must be treated as a capital loss deduction.

In *Skelly Oil* income was received which prior to being taxed was reduced by a 27½% oil depletion allowance. Subsequently the taxpayer had to refund part of this income. The taxpayer sought to deduct the full amount of the refund as an ordinary deduction. The Commissioner disallowed the deduction.

In holding against the taxpayer, the Supreme Court said:

> "[T]he Code should not be interpreted to allow respondent 'the practical equivalent of double deduction,' *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934), absent a clear declaration of intent by Congress. See *United States v. Ludey*, 274 U.S. 295 (1927). Accordingly, to avoid that result in this case the deduction allowable in the year of repayment must

be reduced by the percentage depletion allowance which respondent claimed and the Commissioner allowed in the years of receipt as a result of the inclusion of the later-refunded items in respondent's 'gross income from the property' in those years. Any other approach would allow respondent a total of $1.27½ in deductions for every $1 refunded to its customers.

"Under the annual accounting system dictated by the Code, each year's tax must be definitely calculable at the end of the tax year. 'It is the essence of any system of taxation that it should produce revenue ascertainable and payable to the government, at regular intervals.' *Burnet v. Sanford & Brooks Co., supra,* at 365. In cases arising under the claim-of-right doctrine this emphasis on the annual accounting period normally requires that the tax consequences of a receipt should not determine the size of the deduction allowable in the year of repayment. There is no requirement that the deduction save the taxpayer the exact amount of taxes he paid because of the inclusion of the item in income for a prior year. See *Healy v. Commissioner, supra.*

"Nevertheless, the annual accounting concept does not require us to close our eyes to what happened in prior years. For instance, it is well settled that the prior year may be examined to determine whether the repayment gives rise to a regular loss or a capital loss. *Arrowsmith v. Commissioner,* 344 U.S. 6 (1952). The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordi-

nary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result.

* * * * *

"This result does no violence to the annual accounting system. Here, as in *Arrowsmith*, the earlier returns are not being reopened. And no attempt is being made to require the tax savings from the deduction to equal the tax consequences of the receipts in prior years. In addition, the approach here adopted will affect only a few cases. The percentage depletion allowance is quite unusual; unlike most other deductions provided by the Code, it allows a fixed portion of gross income to go untaxed. As a result, the depletion allowance increases in years when disputed amounts are received under claim of right; there is no corresponding decrease in the allowance because of later deductions for repayments. Therefore, if a deduction for 100% of the repayments were allowed, exery time money is received and later repaid the taxpayer would make a profit equivalent to the taxes on 27½% of the amount refunded. In other situations when the taxes on a receipt do not equal the tax benefits of a repayment, either the taxpayer or the Government may, depending on circumstances, be the beneficiary. Here, the taxpayer always wins and the Government always loses. We cannot believe that Congress would have intended such an inequitable result." 394 U.S. at 684-85 (Footnotes omitted.)

To like effect see: *Commissioner v. Anders,* 414 F.2d 1283 (10th Cir.), cert. denied, 38 U.S.L.W. 3210 (U.S.), rehearing denied, 38 U.S.L.W. 3255. See also *Tennessee Foundry & Machine Co. v. Commissioner,* 399 F.2d 156 (6th Cir.).

The Tax Court predicated its opinion in the present case upon the overriding business purpose of the taxpayer in making the payment to General Motors under § 16(b). We find this business purpose to be irrelevant in determining whether the tax benefit doctrine of *Arrowsmith*, applies. It is a fundamental rule of taxation that form and labels must yield to reality. The taxpayer here, as in *Skelly Oil* received income which was taxed at reduced rates, thereby receiving a tax benefit. In the present case, as in *Skelly Oil*, the taxpayer was required to give up a part of that income. Under *Arrowsmith* and *Skelly Oil*, when income is given up, which in its inception was taxed at reduced rates, the taxpayer is not permitted to enjoy preferred treatment twice by deducting in full the extra amount given up as an ordinary deduction.

The taxpayer contends that there is no integral relationship between the 1962 sale, the 1963 purchase and the 1963 payment. This contention is contradicted by his own testimony:

> "Q. In 1962, did you have occasion to review your estate plan and wills?
>
> "A. Yes.
>
> "Q. With whom did you conduct this review?
>
> "A. With yourself and Mr. Hupp of the National Bank of Detroit.
>
> "Q. What was the result of such review?
>
> "A. I was advised to make a purchase of stock.
>
> "Q. Were you advised to sell a number of GM stock?
>
> "A. Yes.
>
> "Q. What was the reason for selling the stock?
>
> "A. *To get the money to make the purchase of the stock.*" (Emphasis supplied.)

There can be no doubt that the § 16(b) payment made by the taxpayer to General Motors, even though made for business purposes, had its inception in the sale of his General Motors stock in 1962. The purpose of the 1962 sale was to "get the money" to exercise the taxpayer's stock option in 1963. Except for the sale of the stock in 1962, which resulted in a long-term capital gain, the alleged violation of § 16(b) and the payment of $17,939.20 to General Motors would never have occurred.

Reversed and remanded.

APPENDIX C

ORDER DENYING PETITION FOR REHEARING

No. 19,950

UNITED STATES COURT OF APPEALS
for the Sixth Circuit

William L. Mitchell, et al.,
Petitioners-Appellees,

v.

Commissioner of Internal Revenue,
Respondent-Appellant.

(Filed August 7, 1970)

Before Phillips, Chief Judge, Edwards and Peck, Circuit Judges.

The suggestion for a rehearing *en banc* having come on to be considered, and no active judge of this Court having suggested a rehearing *en banc*, and the petition having been considered on its merits by the original hearing panel,

It is Ordered that the petition be and hereby is denied.

Entered by order of the Court.

/s/ Carl W. Reuss
Clerk